

# The Dollar's Vulnerability and the Threat to National Security

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## Introduction

The decline of the United States as a great power has been a popular topic with pundits for years. The same is true of the United States dollar (subsequently referred to as “dollar”) and its role as the world’s dominant international currency. Not surprisingly, the loss of such currency status has historically coincided with the loss of great power status.<sup>1</sup> These two interrelated issues have recently become of increasing concern due to rising levels of United States deficit spending and a growing debt burden. The unease revolves around whether the dollar’s status, and by extension, the United States’ international leadership role, are still viable as its debt approaches record levels in absolute terms. Epitomizing this concern are the recent calls for an alternative to the dollar as the world’s central international currency by China, Russia, Brazil, and some OPEC nations, coupled with increasing pressure from large vote-carrying members of the International Monetary Fund (IMF) for the United States to reduce its voting shares.

The purpose of this study is to identify looming vulnerabilities that may lead to the demise of the dollar undermining United States power and compromising its national security. In identifying vulnerabilities, we consider economists’ views of international currency dominance and Benjamin J. Cohen’s state of power theory, apply those views to the historical case of the United Kingdom, and then compare that to the present-day US in light of the National Security Strategy.

## Modeling for Analysis

There are two opposing thoughts on the potential decline of the United States’ international leadership that help shape this examination. Paul Kennedy, of Yale University, wrote in 1987 that the transition between great powers was a slow process that centered on the incumbent’s struggle to balance short-term national security demands and long-term economic interests.<sup>2</sup> The inability to do so can lead to high levels of debt undermining overall economic viability. Niall Ferguson, of Harvard University, disagrees with Kennedy’s model of a gradual rise and fall. Instead, he suggests great powers are complex adaptive systems that collapse as the result of sudden and catastrophic malfunctions, caused by their inability to finance public debt that accumulates due to high levels of deficit spending.<sup>3</sup> The United States has avoided this problem, in part, because of the dollar’s international role.

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<sup>1</sup> Jeffrey A. Frankel, “Still the Lingua Franca: The Exaggerated Death of the Dollar” *Foreign Affairs* 74, no. 4 (July 1995), 12.

<sup>2</sup> Paul Kennedy, *The Rise and Fall of the Great Powers* (New York: Vintage Books, 1989), 536, 540.

<sup>3</sup> Niall Ferguson, “Complexity and Collapse: Empires on the Edge of Chaos,” *Foreign Affairs* 89, no. 2 (March/ April 2010): 20, 30.

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The central purpose of an international currency today is to serve “as a store of value for central banks’ and governments’ international reserves.”<sup>4</sup> While this may be the central role of today’s international currencies, there are two other functions: to serve as units of account denominating international obligations and pricing commodities, and as media of exchange for transactions between other currencies.<sup>5</sup> The dollar is currently the primary international currency fulfilling each of these roles, which provide financial and security benefits to the US. Two principle benefits of the dollar’s special status as the leading international currency are a regular inflow of foreign financing that keeps the United States interest payments on its debt low and its current and capital accounts in balance, thus enabling relatively large and sustainable deficit spending.<sup>6</sup>

Based on the theory of international currencies, a nation must have a relatively large economy for its currency to ascend to an international role. Once elevated, it becomes a competitor for the predominant role in international finance, which it will only achieve if it is dominant in trade. Therefore, it must have the dominant share of world trade volume and should lead in the value of its exports. Helen Rey of the London Business School finds that trade flows are the key determinant in currency internationalization.<sup>7</sup> Paul Krugman finds that only the currency of a nation that is important in world payments can serve as an international vehicle currency and that once that role is established it is self-reinforcing.<sup>8</sup> The payments are the result of imports and exports; thus, to be important in world trade a nation must be active in trade, which reinforces Rey’s findings. The process is reinforcing because once the role of vehicle currency is established, the transactions in that currency swell due to decreasing transaction costs. Krugman also finds that the process of change between vehicle currencies is catastrophic, as an amplifying loop of declining trade leads to increasing transaction costs and further declines in trade volume.<sup>9</sup>

Based on the ideal economic structure, the nation of the lead international currency should also be a net creditor and possess a current account surplus. Once this structure has been achieved, the nation enjoys financial benefits as well as increased power in the international state system. Having gained this predominant position, the importance of the currency in trade reinforces the currency’s strength. The nation risks losing its position as an international currency by running up a gross government debt that results in a debt to GDP ratio of over 90% which correlates with increased inflation and low real economic growth.<sup>10 11</sup> This erodes confidence in the currency as a store of

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<sup>4</sup> Barry Eichengreen, "Sterling's Past, Dollar's Future: Historical Perspectives on Reserve Currency Competition" (Lecture, Economic History Society, Leicester, UK, April 10, 2005), 2.

<sup>5</sup> Paul Krugman, "Vehicle Currencies and the Structure of International Exchange," *Journal of Money, Credit, and Banking*, 12, no. 3, (August 1980): 513.

<sup>6</sup> Congressional Research Service, *Dollar Crisis: Prospects and Implications*, by Craig K. Elwell, RL34311 (Washington, DC: Government Printing Office, January 8, 2008), 6.

<sup>7</sup> Rey, Helene. "International Trade and Currency Exchange." *The Review of Economic Studies* 68, no. 2, (April 2001): 457.

<sup>8</sup> Krugman, "Vehicle Currencies and the Structure of International Exchange," 523.

<sup>9</sup> Ibid.

<sup>10</sup> Carmen M. Reinhart and Kenneth S Rogoff, "Growth in a Time of Debt," National Bureau of Economic Research working paper 15639, Cambridge, MA (January 2010): 9.

<sup>11</sup> Reinhart and Rogoff, find a positive correlation between rising inflation and a high gross government debt to GDP ratio, defined as higher than 90% in the United States. Therefore, the ratio of gross government debt to GDP should be a key factor in evaluating the fit of an international currency for a leading reserve role.

value and fits with the logic that a nation should only resort to expansionary fiscal policy in times of desperation.

Finally, Benjamin J. Cohen's state of power theory has noteworthy application. Cohen identifies two operational dimensions of state power: the ability to control the behavior of others and the ability to act unilaterally.<sup>12</sup> These dimensions operate within a framework of two kinds of state power in a political economy, relational and structural—relational being the ability to get another power to do something they would not normally do, while structural power is the ability to shape the framework of international relations.<sup>13</sup> Clearly, both types of power are important, but structural power, by allowing a nation greater influence in creating future systems, is the more beneficial. Cohen finds that the store of value role of an international currency increases the issuing nation's autonomy, thus increasing its relational power.<sup>14</sup> The more significant structural power derives from a currency's international dominance of all three roles of money:

1. as a store of value for central banks' and governments' international reserves
2. as a unit of accounting denominating international obligations and pricing commodities
3. as a unit of exchange for transactions between other currencies<sup>15 16</sup>

Thus, all nations whose currency serves as an international reserve enjoy a proportional increase in international autonomy and influence. However, the nation whose currency dominates all three roles has the advantage of shaping the rules of international relations. It follows that the dollar's central place in all three roles contributes to the foundation of United States international power. Therefore, preserving the dollar's predominance should be treated as a national security issue. Losing the dominant currency position puts at great risk the dollar's valuation resiliency and the international appeal of dollar denominated debt (currently two thirds of all foreign held reserves are denominated in dollars or dollar denominated debt). This would ultimately impact the US ability to further finance its growing debt—a debt often used as an economic stimulant and a means to help finance the defense budget, as well as diplomatic interests around the world. Furthermore, major imported commodities that are denominated in dollars, such as oil, would likely become valued in another currency, adversely affecting the dollar's purchasing power of such commodities and further adding to a growing US trade deficit.

## Historical Perspective: The Sterling-Dollar Transition

The transition between the sterling and the dollar is significant for two reasons. First, it is the most recent such reordering of the international financial system. Second, according to Eichengreen, based on the role of an international currency as a store of value for central banks and governments, it is the only such transition in history.<sup>17</sup>

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<sup>12</sup> Benjamin J. Cohen, "Currency and State Power," Presented at a conference to honor Stephen D. Krasner, Stanford University, (December 4, 2009): 4.

<sup>13</sup> Susan Strange, *States and Markets*, (London: Pinter Publishers, 1994): 24-25.

<sup>14</sup> Cohen, "Currency and State Power," 21.

<sup>15</sup> Barry Eichengreen, "Sterling's Past, Dollar's Future: Historical Perspectives on Reserve Currency Competition," 2.

<sup>16</sup> Krugman, "Vehicle Currencies and the Structure of International Exchange," 523.

<sup>17</sup> Barry Eichengreen, "Sterling's Past, Dollar's Future: Historical Perspectives on Reserve Currency Competition"

Chinn and Frankel provide a useful summary of this transition, which began in the late nineteenth century and lasted until the conclusion of World War II. The United States economy surpassing the British economy in size was the first key event in the transition. This occurred in 1872, but the United States lacked a robust financial system until the creation of a central bank in 1913.<sup>18</sup> During World War I, the United States and the United Kingdom change roles in terms of debtor and creditor and trade balances. The United Kingdom became a net debtor, while the United States assumed the role of net creditor as its exports surpassed those of the United Kingdom in 1915.<sup>19</sup> Despite the dollar's emergence and growing role in international trade and finance, the level of foreign-owned liquid sterling assets was twice that of the dollar as late as 1940, but by 1945 the currencies reserve positions were reversed.<sup>20</sup> This paints a picture of a slow shift in the underlying structure conditions, which were necessary, but not sufficient for the transition. The system was only tipped in the dollar's favor through the crisis presented by the Second World War.

## Analysis of the Sterling's Economic Foundation

Various estimates of economic size have the United States surpassing the United Kingdom before the beginning of the 20<sup>th</sup> century. As stated, Chinn and Frankel put the exact year as 1872. Table 1 shows that the United States had the largest economy and the fastest rate of growth throughout the first half of the twentieth century. The most notable aspect of this data is the dramatic growth of the United States' economy relative to the other nations. Despite having become twice the size of the British economy by 1913, the dollar did not claim the primary role in the international economy until the end of World War II. This is not unexpected. Having a relatively large economy was a necessary, but not sufficient, condition for a nation's currency to achieve a primary international role.

**Table 1 - GDP (billions of 1955 US dollars)**

Year	United States	United Kingdom	France	Germany
1899	59	34	14	29.3
1913	97	42	16	37.5
1929	168	42	25	40.5
1937	171	50	22.4	46.5
1950	294	54.7	32.4	31.8

Source: Alfred Maizels, *Industrial Growth and World Trade* (Cambridge: Cambridge University Press, 1963), 531.

The data appear to support Rey's finding that GDP is not the primary factor in determining the internationalization of currency. It may also reflect the inertia of incumbency due to the self-reinforcing tendencies of holding the predominant position. Chinn and Frankel note that part of the explanation lies in the fact that the United States' financial system was not properly developed until

<sup>18</sup> Chinn and Frankel, "The Euro May Over the Next 15 Years Surpass the Dollar as Leading International Currency," 1.

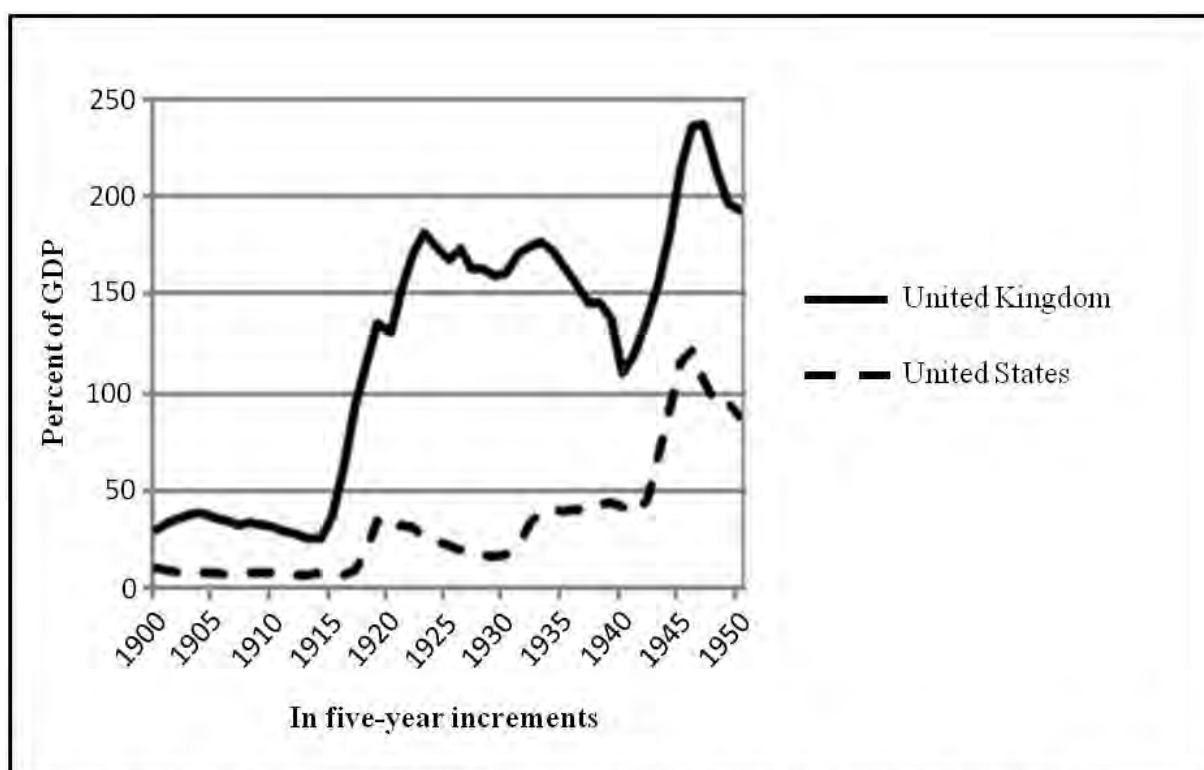
<sup>19</sup> Ibid.

<sup>20</sup> Ibid.

the creation of the central bank in 1913. Even with this condition met, it would take an additional 30 years and the events of World War II for the dollar to claim the top spot.

One explanation for the slow relative growth of the United Kingdom's economy, compared to the United States can be found in each nation's debt to GDP ratio. Figure 1 shows that the United Kingdom surpassed the 90% threshold identified by Reinhart and Rogoff in 1917, exceeding 200% briefly from 1945 thru 1948. As expected, this correlates with a slower rate of economic growth. However, as the data in table 1 show, the United Kingdom's economy grew more than the United States' from 1929-1937, during the Great Depression. This serves to undermine a notion of a causative link between high levels of debt to GDP and slow economic growth. However, there are signs that the levels of debt carried by the United Kingdom were eroding international confidence in the sterling as a store of value.

**Figure 1 – Percentage of Government Gross Debt to GDP Ratios (US and UK)**



Source: U.K. Public Spending, "UK Total Government Debt Current\_Historical As Percent GDP," [http://www.ukpublicspending.co.uk/uk\\_national\\_debt](http://www.ukpublicspending.co.uk/uk_national_debt) (accessed June 3, 2010); U.S. Government Spending, "US Federal Debt As Percent of GDP," [www.usgovernmentspending.com](http://www.usgovernmentspending.com) (accessed June 3, 2010).

The dramatic increase in British debt coincides, not unexpectedly, with the transition of the nation's net investment position. In the years leading up to World War I, The United Kingdom maintained a current account surplus despite a persistent trade deficit.<sup>21</sup> This is due to large and growing income

<sup>21</sup> Laney, "The Reserve Role of the Dollar and the United States as Net Debtor," 5.

receipts from overseas investments, which were reinvested overseas annually.<sup>22</sup> These long-term loans to the rest of the world kept the United Kingdom's net investment position positive, a condition that would change during World War I. During the war, the United Kingdom transitioned to a net debtor while the United States transitioned to a net creditor due in large part to British borrowing to fund the war.<sup>23</sup> While the British current account recovered during the 1920s, the deficits returned in the 1930s to combine with defaults on debt, and declining values of overseas assets, eroding the nation's net worth.<sup>24</sup> The existing debt, defaults on current obligations, and persistent current account deficits resulted in the erosion of confidence among investors, leading them to diversify their assets by selling off their sterling reserves.

Eichengreen points out that there was a perceptible shift occurring in reserve currency allocation during the interwar years. He notes that the dollar's increasing role in trade as a unit of account and in payments contributed to international diversification in reserve currency holdings, with the sterling holding a 57% share and the dollar rising to 19% in 1928.<sup>25</sup> This is in line with estimates from Chinn and Frankel that the level of foreign-owned liquid sterling was double that of dollars as late as 1940.<sup>26</sup> However, despite high levels of debt and sustained current account deficits, the sterling maintained its leading international role.

Rey's hypothesis was that trade volume was the key determinant in the internationalization of currency. Matching this with Krugman's finding that the process of transition would be catastrophic for the incumbent, it would follow that the sterling would give way to the dollar rapidly following the United States' assumption of the top place in trade volume. Table 2 shows the United States gaining the largest share of world trade volume sometime between 1913 and 1928. Yet, this only led to slight diversification away from the sterling, not a catastrophic collapse.

**Table 2 – Percent Share of World Trade**

Year	United States	United Kingdom	France	Germany
1890	9.8	22.4	10.2	10.3
1913	12.9	15.5	7.3	12.1
1928	17.3	13.7	6.1	9.3
1937	16.0	14.1	4.8	8.3

Source: Simon Kuznets, *Modern Economic Growth* (New Haven: Yale University Press, 1966), 306-308.

A partial explanation for the lack of a collapse might be the relative value of each nation's exports as displayed in Table 3. According to these data, while the United States accounted for the largest share of world trade (ie, total value of exports *plus* imports) in 1928, in 1929 British exports were still

<sup>22</sup> Roderick Floud and Donald McCloskey, *The Economic History of Britain Since 1700: Volume 2: 1860 to the 1970s*, (Cambridge: Cambridge University Press, 1981), 289.

<sup>23</sup> Chinn and Frankel, "The Euro May Over the Next 15 Years Surpass the Dollar as Leading International Currency," 1.

<sup>24</sup> Floud and McCloskey, *The Economic History of Britain Since 1700*, 300.

<sup>25</sup> Eichengreen, "Sterling's Past, Dollar's Future," 9.

<sup>26</sup> Chinn and Frankel, "The Euro May Over the Next 15 Years Surpass the Dollar as Leading International Currency," 1.

slightly more valuable. Therefore, evaluation of the trade role may need to balance volume and value.

**Table 3 - Value of Merchandise Exports (millions of 1990 US Dollars)**

Year	United States	United Kingdom
1870	2,495	12,237
1913	19,196	39,348
1929	30,368	31,990
1950	43,114	39,384

Source: Angus Maddison, *The World Economy* (Organization for Economic Cooperation and Development, 2007), 360.

It should be noted that the value of the United States' exports was increasing from 1913-1929, while that of Britain were falling over the same period. This leads to the inference that the value of United States exports overtook those of Britain much earlier than the 1950 data can confirm. Yet it was still at least another 15 years before the dollar would surpass the sterling as an international currency.

From the 1870s through 1939, the economic balance of power shifted from The United Kingdom to the United States. It began with the United States economy becoming the world's largest. As the United States developed its financial institutions, the dollar began to play an important role in the international system. During World War I, the two nations exchanged their net investment positions, with the United Kingdom becoming a net debtor nation and the United States becoming a net creditor. The high levels of British debt and persistent deficits contrasted with the relative economic health of the United States, which slowly translated into patterns of international trade. However, the sterling maintained its role even after the United States held the dominant role in international trade. It took another world war to effect the change.

These slow foundational changes resulted in conditions where British liquid assets and exports were insufficient to finance their war effort.<sup>27</sup> In addition, the United States would not loan it money because it had stopped paying interest on debt from the First World War.<sup>28</sup> The loss of investor confidence resulted in an unwillingness to provide further loans. The United Kingdom was forced to deplete their reserves and to sell its illiquid assets under unfavorable terms.<sup>29</sup> The loss of these assets denied the United Kingdom the income that had kept its current account balance positive for decades and later, at least sustainable. Finally, after the Second World War crippled the United Kingdom's economy, the dollar replaced the sterling as the dominant international currency. This transition in economic power would translate into changes in state power as illustrated by the following two examples.

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<sup>27</sup> Floud and McCloskey, *The Economic History of Britain Since 1700*, 306.

<sup>28</sup> Ibid.

<sup>29</sup> Ibid.



## Bretton Woods – An Example of Structural Power

The creation of the Bretton Woods System during World War II provides an example of structural power and the role of economic strength as its foundation. American and British policy makers developed a joint plan for post war monetary arrangements that was adopted by 44 nations at the 1944 Bretton Woods conference.<sup>30</sup> The fact that the United States and the United Kingdom developed a plan that was subsequently adopted by the international community demonstrates that those two nations possessed structural power, or the ability to shape the framework of international relations. They used this power in an attempt to create an international system that reduced trade barriers, promoting free trade as a way to raise standards of living, create interdependencies, and cement post war peace through global institutions, including the International Monetary Fund (IMF) and the World Bank.<sup>31</sup> The system attempted to lower trade barriers by reconciling exchange rate stability and domestic economic autonomy by creating an explicit code of conduct for the international monetary system and institutional controls centered on the IMF.<sup>32</sup> Because the United States possessed the largest economy, it held the largest share in the IMF stabilization fund intended to finance balance of payment deficits, reconstruction and long-term development.<sup>33</sup> In controlling the largest share of these institutions, the United States benefited greatly through an increased ability to control the behavior of other nations in the international system. The Suez Crisis demonstrates the importance of this power to a nation pursuing its national interests.

## The Suez Crisis – Lost Autonomy

When Egyptian President Gamal Abdel Nasser nationalized the Suez Canal on July 26, 1956, he triggered an international crisis that demonstrated the importance of autonomy in international relations and made clear that the United Kingdom had lost a measure of theirs. In the days following the nationalization, British Prime Minister Anthony Eden stated that the incident was a vital national interest because 80% of Western Europe's oil and commerce between the United Kingdom, India, Australia, and British colonies passed through the canal.<sup>34</sup> The British collaborated with the French and Israelis on Operation MUSKETEEER, a military operation launched on November 5<sup>th</sup> to seize the Suez Canal.<sup>35</sup> However, significant reserve losses and the economic impacts of oil shortages combined to cripple the British effort.

The action had cost the British \$400 million in reserves by the end of the month and the United States would not support aid from international institutions without a complete withdrawal of forces.<sup>36</sup> Britain did not have an alternative source of funds. The United States controlled its own

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<sup>30</sup> Oatley, *International Political Economy*, 225.

<sup>31</sup> Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle for the World Economy*, (New York: Free Press, 2008), 387-388.

<sup>32</sup> Oatley, *International Political Economy*, 225.

<sup>33</sup> *Ibid.*, 227-228.

<sup>34</sup> Diane B. Kunz, *The Economic Diplomacy of the Suez Crisis*, (Chapel Hill: The University of North Carolina Press, 1991): 79.

<sup>35</sup> *Ibid.*, 117.

<sup>36</sup> *Ibid.*, 138, 150.

markets as well as the IMF and World Bank.<sup>37</sup> At the command of the United States, the United Kingdom was forced to recant an action it had labeled a vital national interest because it had run out of money. A great power must be able to act unilaterally to protect its national interests and the United Kingdom had lost this capacity with the loss of its economic dominance. Britain could forego American approval and friendship, but could not forfeit American money.<sup>38</sup>

## Lessons From the British Experience

This transition illustrates a number of important points. Overall, it demonstrates a synthesis of Kennedy's and Ferguson's theories. The decline of the British Empire with the sterling as the dominant international currency was the culmination of over 50 years of slowly shifting economic fundamentals. The Suez crisis ultimately revealed that a shift in the balance of power had occurred between the UK and the US. The next important point is that despite high levels of debt and persistent current account deficits, the international community continued to provide financing to the United Kingdom. This continued despite the existence of a nation with a larger economy and an equal, or greater, role in trade. This reinforces Krugman's finding that once a currency becomes the leading international currency its role is self-reinforcing. The collapse in the face of a crisis may indicate that he was also correct in his assessment that a currency's fall from the top spot would be catastrophic. A final important finding is that the British collapse followed the government's sale of its illiquid income producing assets. The loss of these assets prevented the United Kingdom from retaining its position of global leadership. In the end, the reasons for the collapse of the British Empire and the sterling are complex, but the primary lesson appears to be that through excessive reliance on deficit spending, the government robbed itself of the ability to function autonomously when it needed to.

While this overview is useful in illustrating these points, it is important to acknowledge the context of that transition. American isolationism and the Great Depression may have slowed the process. These factors probably pushed investors to the sterling, which had the trust of the international community. This would be similar to the reaction of the international community to the latest financial crisis.<sup>39</sup>

## Prospects for the Dollar

### *Analysis of the Dollar's Economic Foundation*

The current position of the United States appears to be different from that faced by the United Kingdom a century ago. Unlike the position of the United Kingdom at the beginning of the 20<sup>th</sup> century, the United States still has the world's largest economy. Table 4 lists the ten largest economies measured by GDP. Only the Eurozone (European Union countries that also use the euro as a common currency) is close to matching the United States' economic size.

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<sup>37</sup> Ibid., 193

<sup>38</sup> Ibid.

<sup>39</sup> Eichengreen, "The Dollar Dilemma," 55-56.

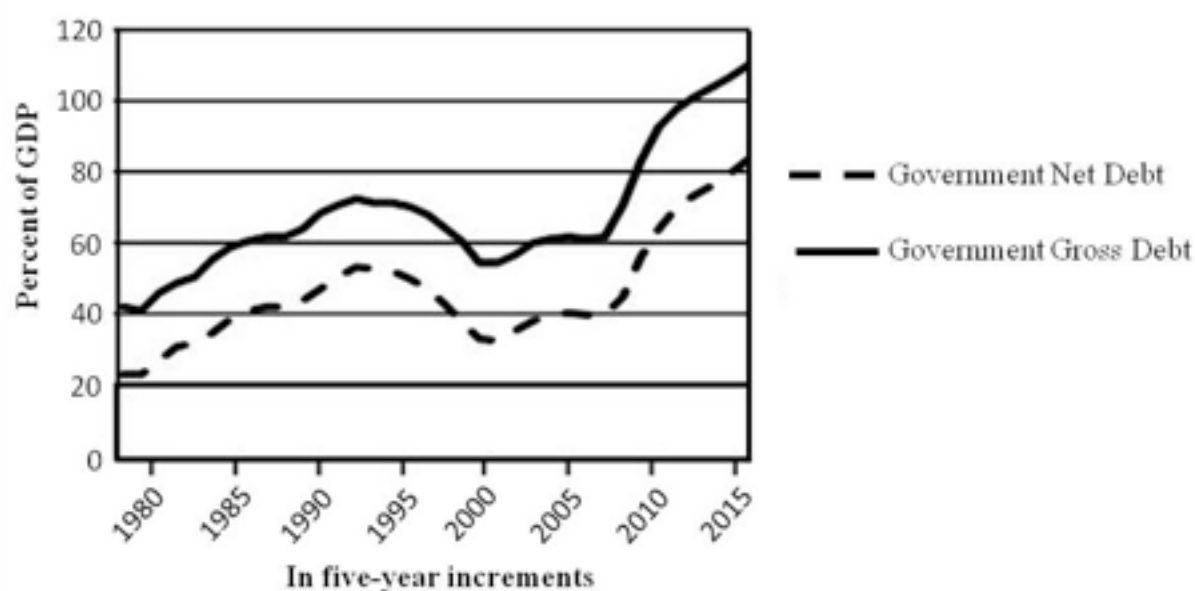
**Table 4 - Top Ten World Economies (including Eurozone)**

Rank	Country	2008 GDP (millions of U.S. dollars)	% of World GDP
1	United States	14,093,310	23.3%
2	Eurozone	13,580,866	22.4%
3	Japan	4,910,840	8.1%
4	China	4,326,996	7.1%
5	Germany	3,649,494	6.0%
6	France	2,856,556	4.7%
7	United Kingdom	2,674,057	4.4%
8	Italy	2,303,079	3.8%
9	Russian Federation	1,679,484	2.8%
10	Spain	1,604,235	2.6%

Source: The World Bank, "World Bank Data Catalog." <http://data.worldbank.org/data-catalog> (accessed June 3, 2010).

As reflected in figure 2, another difference is that the United States just crossed the threshold of 90% debt to GDP ratio in 2010. As was demonstrated in the British example, it is possible for a lead nation to endure this level for decades. However, the rising levels of debt projected by the IMF are cause for concern, as it may cause investors, both private entities and foreign governments, to seek other destinations for their capital. Examination of the trade roles provides further insight into the dollar's economic foundation and identifies additional concerns.

**Figure 2 – Percent of US Government Debt to GDP Ratio (Projected Through 2015)**



Source: International Monetary Fund, "World Economic Outlook Database April 2010," <http://www.imf.org/external/pubs/ft/weo/2010/01/weodata/index.aspx> (accessed August 15, 2010).

As the British case demonstrated, it is prudent to consider both trade volume and export values to analyze the strength of the United States and the dollar. According to table 5, the United States still accounts for the greatest share of the world's trade volume (exports plus imports). However, six of the top ten nations, in terms of trade volume, are members of the Eurozone. From the table, their combined share of world trade volume is more than twice that of the United States, which, according to Rey, is the key determinant of the dominant international currency. However, the British case showed that the United States had passed the United Kingdom in terms of trade volume by 1928 without causing the sterling to collapse.

**Table 5 - 2009 Percent Share of World Merchandise Trade**

Rank	Country	2009 Share of World Volume
1	United States	10.6%
2	China	8.8%
3	Germany	8.2%
4	Japan	4.5%
5	France	4.1%
6	Netherlands	3.8%
7	United Kingdom	3.3%
8	Italy	3.2%
9	Belgium	2.9%
10	Republic of Korea	2.7%

Source: World Trade Organization, *World Trade 2009 Prospects for 2010* (Geneva: WTO, March 2010), 10.

**Table 6 - Value of Merchandise Exports (US dollars)**

Rank	Country	2009 Export Value
1	China	\$1,204,000,000,000
2	Germany	\$1,159,000,000,000
3	United States	\$1,046,000,000,000
4	Japan	\$542,300,000,000
5	France	\$472,700,000,000
6	Netherlands	\$417,600,000,000
7	Italy	\$412,900,000,000
8	Republic of Korea	\$373,600,000,000
9	United Kingdom	\$357,300,000,000
10	Canada	\$323,400,000,000

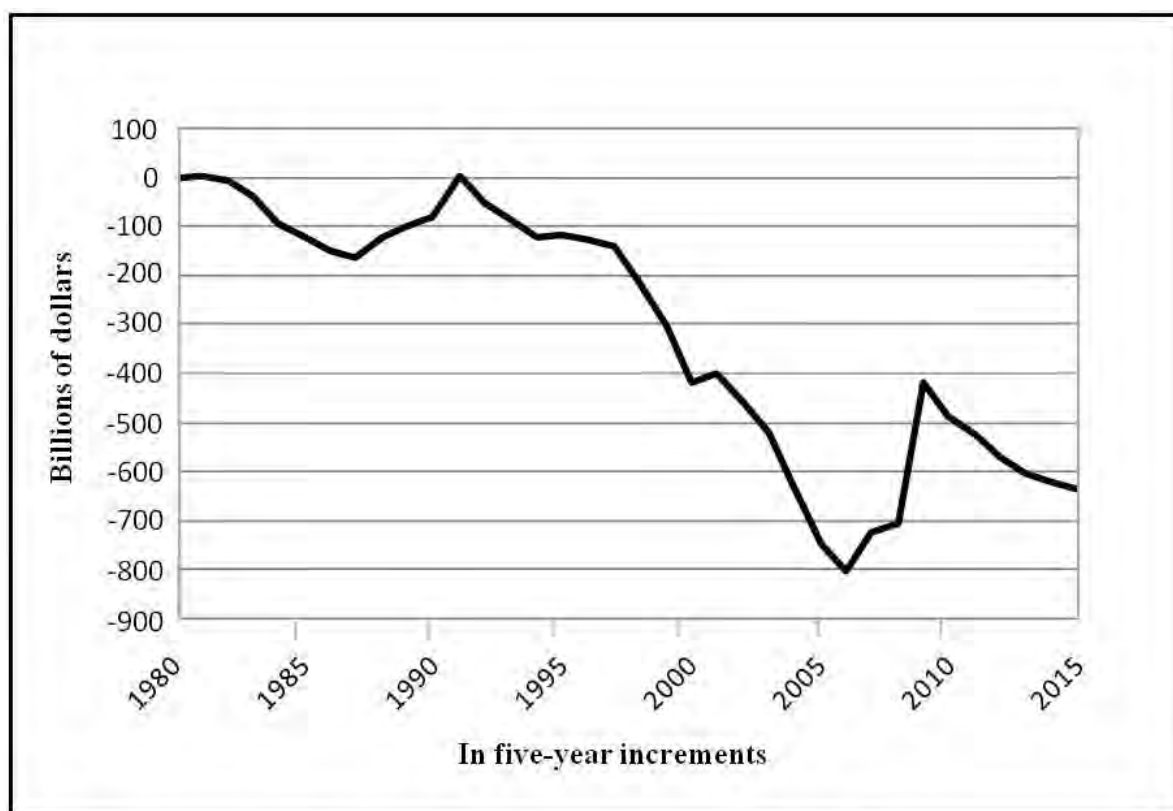
Source: CIA Factbook Country Comparison: Exports,” (accessed September 10, 2010).  
<https://www.cia.gov/library/publications/the-world-factbook/rankorder/2078rank.html>

Table 6 shows that the United States does not hold the lead in terms of the value of its exports either. It currently sits third behind China and Germany. The fact that Germany is in front of the United States in terms of export value means that the Eurozone leads the United States in both measures of trade.

At this point in the evaluation, there are indicators that the dollar may be vulnerable. The economic foundation of the Euro is nearly the same size as the United States, and the Eurozone accounts for more international trade in terms of both volume and value. Combined with the high levels of debt to GDP in the United States, which are expected to correlate with increasing inflation and slow economic growth, it is reasonable to expect investors may begin looking to diversify their holdings as they did during the interwar period. Another factor, which will erode investor confidence in the dollar as a store of value, is a growing trade deficit that would put downward pressure on the dollar if investors stop buying the currency as a reserve. This may lead to a rapid collapse as predicted by Krugman's theory.

The data show that the United States current account is increasingly negative which will heighten the vulnerability of the dollar if it follows current projections. Figure 3 shows a sharply negative projection of the United States' current account between 1998 and 2006. The data show that the deficit nearly quadrupled from \$213 billion in 1998 later bottoming at \$803 billion in 2006, before a slight rebalancing in 2007 and 2008.

**Figure 3 - United States Current Account Balance of Payment Data (billions of US dollars)**



Source: International Monetary Fund, "World Economic Outlook Database April 2010," <http://www.imf.org/external/pubs/ft/weo/2010/01/weodata/index.aspx> (accessed August 15, 2010).

The IMF projection for the 2010 current account deficit is \$487 billion, which is still more than double the 1998 level and reverses a three-year trend of reduced current account deficits.<sup>40</sup> While the nation's deficits have come down from their peak in 2006, at nearly 5% of GDP they are too high to control the rising debt and are projected to continue increasing following 2010. A deficit to GDP ratio of 2% would likely prove to be a sustainable level, as it would allow GDP to grow, on average, at a faster rate than debt.<sup>41</sup> This would equate to reducing deficits at 1998 levels, which may or may not be possible without serious tradeoffs.

In order to understand what is possible, it is necessary to understand why the trade deficit is as large as it is. There are two explanations for the emergence of the current global imbalance. The first offered by Ben Bernanke is the "global savings glut," which is the result of the developing world's transition from net borrower to net lender.<sup>42</sup> His argument is that developing countries lost some capacity to borrow because of financial crises in the 1990s. The long-term impact of these crises is that developing nations became less willing to borrow and run budget deficits. They have instead turned to accumulation of foreign exchange reserves by their central banks as a method of national savings. Finally, Bernanke holds that the rise in oil prices has resulted in an abrupt increase in revenue and saving for oil exporting nations. He argues that this excessive savings was attracted to the United States because of the technology boom in the 1990's, the maturity and safety of its capital markets, and the unique role of the dollar as a reserve currency.

The second explanation is the "money glut" as advanced by Martin Wolf.<sup>43</sup> In this view, the United States monetary excess causes low nominal and real interest rates making credit attractive and available to consumers. This has the effect of lowering savings while increasing spending which absorbs imports. The dollar then loses value against floating currencies, but pegged currencies are kept low relative to the dollar by foreign currency intervention. In the end, this view argues that excess money creation by the United States forces the rest of the world to invest in the dollar as a foreign exchange reserve in order to control excessive demand and inflation. As Wolf points out, understanding which view is correct is important; if the savings glut is correct, the adjustment can be controlled, but if the money glut is more accurate then the adjustment will come at the cost of monetary stability.<sup>44</sup>

## Are the Global Imbalances Sustainable?

While there seems to be consensus that the dollar will inevitably lose its predominance, there is wide disagreement on the process of transition and the end state. This is likely due to the uncertainty regarding the true meaning of the United States current account deficits and overall levels of debt. As previously stated, Kennedy and Ferguson have opposing views on the length of a possible

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<sup>40</sup> *World Economic Outlook Database* at the International Monetary Fund website, <https://www.imf.org/external/pubs/ft/weo/2010/01/weodata/index.aspx>, (accessed June 3, 2010).

<sup>41</sup> Michael Mussa, "Exchange Rate Adjustments Needed to Reduce Global Payment Imbalances," In *Dollar Adjustment: How Far? Against What?*, by C. Fred Bergsten and John Williamson, (Washington, D.C.: Institute for International Economics, 2004), 118.

<sup>42</sup> Ben Bernanke, "The Global Savings Glut and the U.S. Current Account Deficit" (The Sandridge Lecture, Virginia Association of Economics, March 10, 2005).

<sup>43</sup> Martin Wolf, *Fixing Global Finance*, (Baltimore, MD: The Johns Hopkins University Press, 2008) 109.

<sup>44</sup> *Ibid.*, 110.

transition. Chinn and Frankel state that the Euro could replace the dollar as a single dominant currency as early as 2015.<sup>45</sup> However, their conclusions were drawn in 2008, and the ongoing European debt crisis will likely impact investor confidence and, at the least, extend that timeline. On the other hand, Eichengreen sees the potential for two or three currencies to share the reserve role in the market in the 2020 – 2040 timeframe.<sup>46</sup> In addition to the uncertainty surrounding the United States' debt level, this disagreement also reflects the lack of numerous historical references.

As stated earlier, the United States current account deficit is not considered indefinitely sustainable along the current trajectory. The question is how much higher can deficits and debt go before an adjustment occurs. Martin Wolf contends that the imbalances are sustainable as long as creditors are willing to finance the United States.<sup>47</sup> What his statement implies is that the creditor nations are making a deliberate choice to buy the dollar and hold it as a reserve. This is in line with the example provided by continuing support for the sterling in the first half of the twentieth century. Therefore, to understand what is sustainable, it is necessary to understand why they continue investing in the dollar.

The theory maintains that the capital will flow to the highest rate of return, seeking the best store of value. The Congressional Research Service offers reasons this might be the case for the United States and the dollar. They are that the United States has enjoyed greater productivity growth than most of the world since the mid 1990's, higher interest rates due to the low level of domestic savings combined with deficit spending, and the theory of diminishing returns which in this case applies to developed countries' need to invest abroad for efficiency reasons.<sup>48</sup> The problem with this is that the returns are likely to get worse due to depreciation of the dollar. If investors are only seeking a high rate of return, they are likely to abandon the dollar.

Paul Krugman argues that the dollar must depreciate. This is the result of his view that the trade deficit is not sustainable, that closing it requires a redistribution of world spending which requires a fall in relative prices of goods produced by the United States.<sup>49</sup> This is nothing different from a normal balance of payments adjustment. The question revolves around the speed of this depreciation.

The dollar was depreciating steadily at a rate of 3-4% annually from 2002-2006, but then declined by 10% in 2007.<sup>50</sup> The trend has been reversed as investors have flocked to the dollar during the recent financial crisis in search of a safe haven. As the world economy recovers, there is no reason to believe that the dollar depreciation will not continue. The crucial question to Krugman "is whether the dollar must eventually depreciate at a rate faster than investors now expect."<sup>51</sup> It is reasonable to infer that the investors expect and accept a rate of depreciation at or below 3-4% annually as they

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<sup>45</sup> Chinn and Frankel, "The Euro May Over the Next 15 Years Surpass the Dollar as Leading International Currency," 18.

<sup>46</sup> Eichengreen, "Sterling's Past, Dollar's Future," 21.

<sup>47</sup> Wolf, *Fixing Global Finance*, 149.

<sup>48</sup> Congressional Research Service, *Is the U.S. Trade Deficit Caused by a Global Saving Glut?* (RL33140, Washington, DC: Government Printing Office, June 20, 2007).

<sup>49</sup> Paul Krugman, "Will There Be a Dollar Crisis," *Economic Policy*, (July 2007), 438.

<sup>50</sup> Congressional Research Service, *The Depreciating Dollar: Economic Effects and Policy Response*, (RL34582, Washington, DC: Government Printing Office, July 17, 2008), 1.

<sup>51</sup> Paul Krugman, "Will There Be a Dollar Crisis," *Economic Policy*, (July 2007), 439.

did from 2002-2006. What is not clear is if they will accept a 10% decline like the one that emerged in 2007. Krugman argues that if investors fail to account for the required devaluation there will be a 'Wile E. Coyote' moment where they look down and realize there is nothing supporting their investment.<sup>52</sup> The question then becomes whether the dollar must depreciate faster than the 3-4% rate.

Krugman evaluates two scenarios for dollar depreciation that help answer this question. The first scenario occurs over 20 years at an annual depreciation rate of 1.75%.<sup>53</sup> This rate of depreciation is clearly under the 3-4 percent depreciation levels of 2002-2006. The problem with this rate is that after accounting for growth and valuation adjustments, it results in a net external debt to GDP ratio of 118%. As previously discussed, that level of external debt to GDP has never been sustained by a large nation, which makes it a dangerous course. In addition, Krugman finds that it might result in foreign ownership of more than one-third of the United States' capital stock.

The second scenario occurs over 10 years at an annual rate of 3.5%.<sup>54</sup> The resultant net external debt to GDP ratio in this scenario, after accounting for growth and valuation adjustments, is only 58%. This scenario also avoids the problem of large-scale foreign ownership of the nation's capital stock. This rate of depreciation is still within the range that was sustained from 2002-2006, indicating that it may be possible to close the United States current account deficit without a major dollar crisis. For this to happen, investors would have to expect and accept the dollar's depreciation and the dollar would have to depreciate no faster than Krugman's projected rate. While it appears that the current global imbalances are not sustainable, it seems plausible that an adjustment does not mean the end of the dollar as the predominant international currency. The fact that investors have already accepted the necessary level of depreciation over a five-year period indicates that they would be willing to accept it over the longer ten-year period in Krugman's model. The reasons for this could be that they are more concerned with the ability to quickly retrieve their investment than they are with pure value retention. If this is the rationale for investment in the dollar, then this is where the true vulnerability of the dollar can be found.

## **A Plausible Future for the Dollar?**

If investors are willing to accept some annual depreciation in exchange for the ability to quickly liquidate their reserves and intervene in a crisis, it should be asked whether there are investors that hold such a large share of United States securities that they alone pose a risk to the dollar's status. It is impossible to know exactly what scenario might emerge to cause the dollar to lose its place as the dominant international currency, but it is certainly possible to evaluate existing vulnerabilities.

Concern that China will seek to liquidate its large share of dollar holdings makes the unlikely assumptions that the rest of the world can absorb their share and that they are willing to accept significant losses as the value of the dollar plummets during the selloff. It could also result from some unforeseen crisis such as another world war, as was the case for the United Kingdom. However, because the United States is reliant on the international community to fund its current budget deficit, the real problem may reside in the economic health of those nations.

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<sup>52</sup> Ibid., 440.

<sup>53</sup> Ibid., 445.

<sup>54</sup> Ibid.



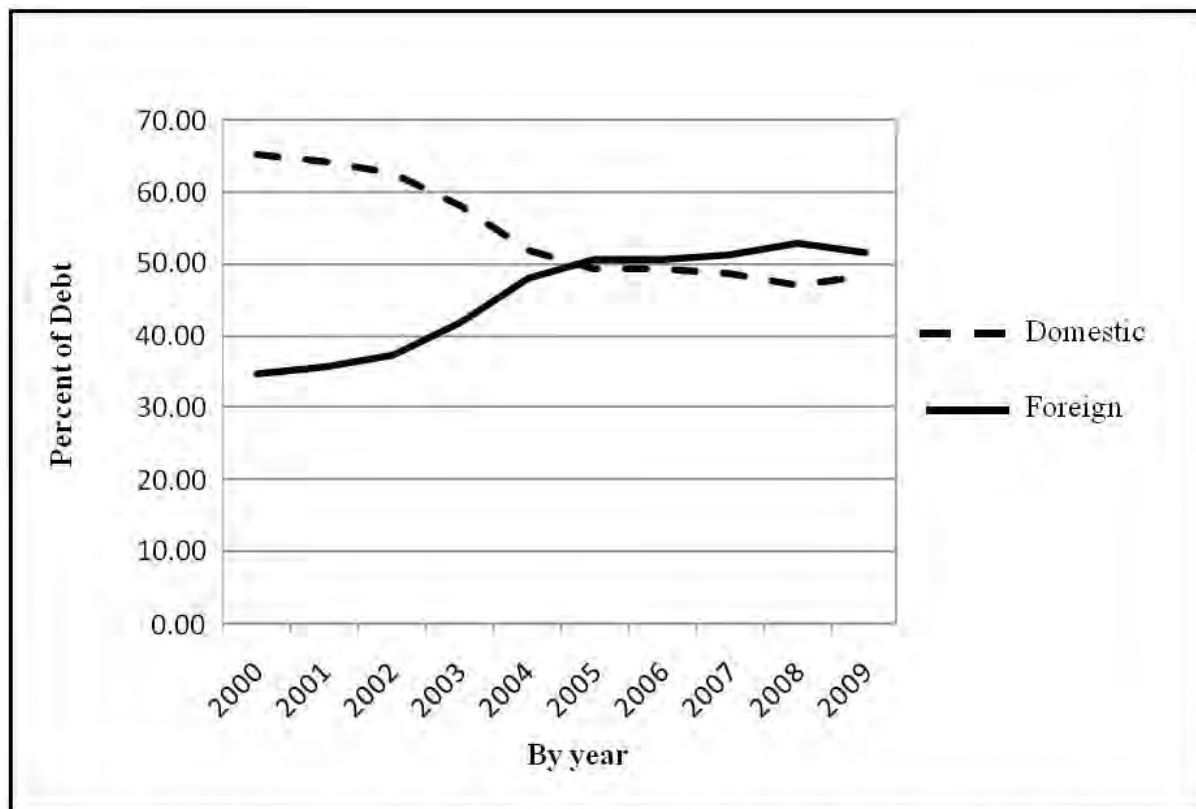
Table 7 shows the four largest holders of United States Treasury securities. This data shows that China is currently reducing its holdings in the dollar, while Japan and the United Kingdom are increasing theirs. Over the last year, Japan has increased its holdings by \$95.4 billion, while the United Kingdom has increased its dollar holdings by \$271.4 billion. The United States' reliance on these nations to fund its budget deficit is reason to examine their economic foundation. Their domestic economic crisis could quickly affect the United States if they are unable to continue purchasing its debt, or if they are forced to liquidate dollar holdings in response.

**Table 7- Major Foreign Holders of US Treasury Securities (billions of US dollars)**

Country	July 2009	January 2010	July 2010
China, Mainland	915.8	889	843.7
Japan	708.2	765.4	803.6
United Kingdom	90.8	208.3	362.2
Oil Exporters	211.8	218.4	223

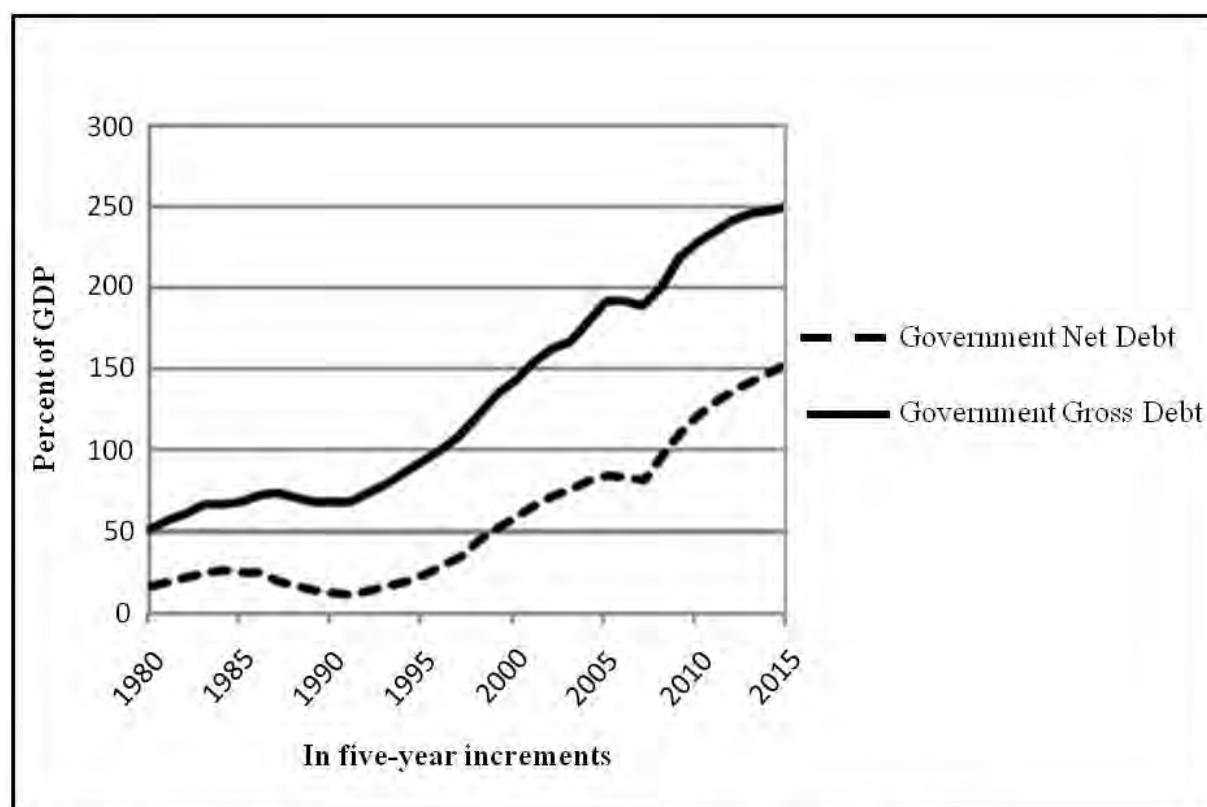
Source: United States Treasury, "Treasury International Capital System - Home Page," <http://www.ustreas.gov/tic> (accessed September 10, 2010).

**Figure 4 - Ownership of US Debt**



Source: United States Treasury, "Treasury Bulletin September 2009," <http://www.ustreas.gov/tic> (accessed June 3, 2010).

**Figure 5 - Japanese Debt to GDP Ratios**

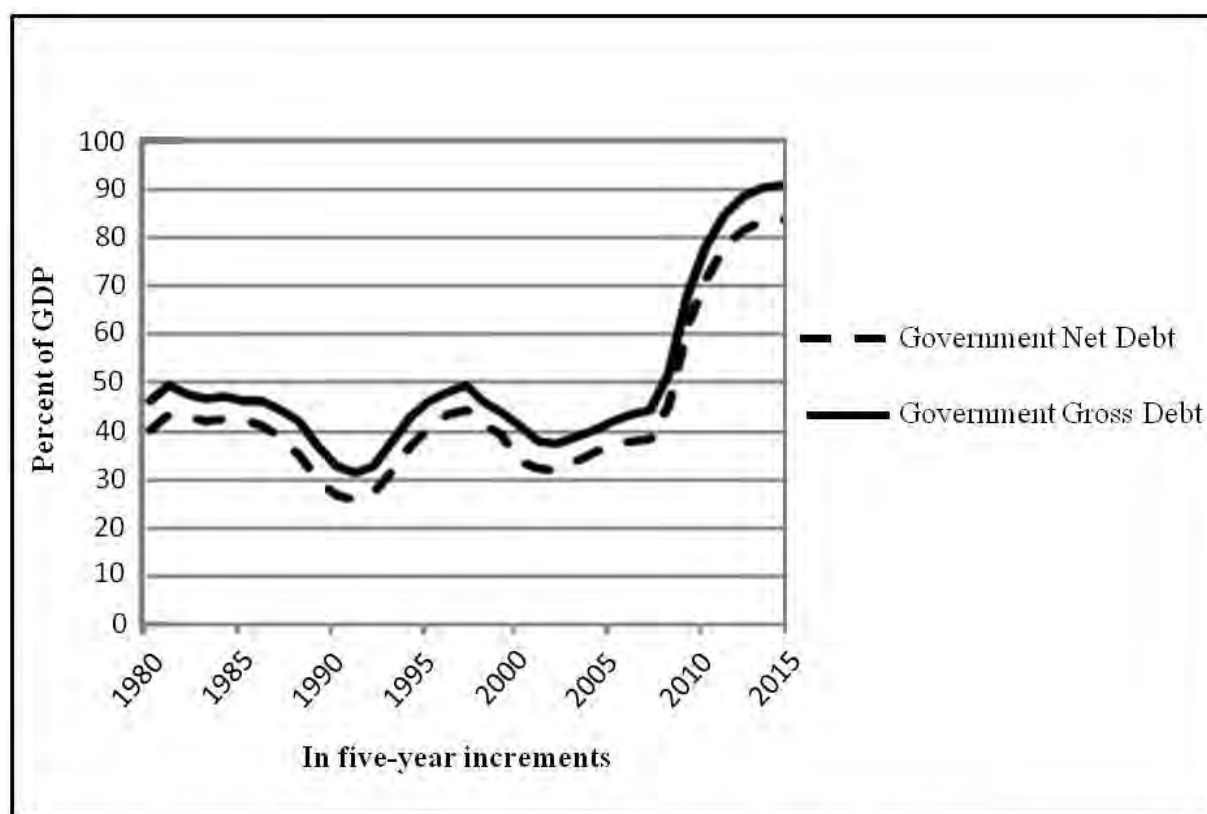


Source: International Monetary Fund, "World Economic Outlook Database April 2010," <http://www.imf.org/external/pubs/ft/weo/2010/01/weodata/index.aspx> (accessed August 15, 2010).

This comes at a time when the United States is increasingly dependent on foreign capital to finance its budget deficits and as a result debt is increasingly owned by foreign investors, both private investors and governments. Figure 4 shows that as a percentage, more than half of the United States public debt is owned by foreigners. However, in real terms, both foreign and domestic investors have been increasing their ownership in recent years. The significance of this is that the United States is increasingly reliant on external sources of capital to fund its budget deficits. Because domestic investors have also increased their purchases of debt, it is not certain that they would be able to offset a rapid international selloff of United States securities. Nor is it likely, that they would be willing to invest in a security that was rapidly losing value. Two potential scenarios that could lead to the fall of the dollar present themselves in this data.

Japan's current role as a major holder of United States debt, combined with its own debt concerns may prove to be the spark that leads to the dollar's loss of international predominance. Figure 5 shows that Japan has a serious structural problem regarding its debt level. Its gross public debt to GDP ratio has been above Reinhart and Rogoff's 90% threshold since 1995, and is projected to reach and surpass levels experienced by The United Kingdom during World War II. Even more concerning, is the projected growth in the net debt to GDP ratio, reaching 150% by 2015. If Japan is forced to sell off its reserves to deal with payment issues, as the United Kingdom was forced to during World War II, it might lead to Krugman's Wile E. Coyote moment. This scenario is more likely when Japan's falling savings rate is considered. Furthermore, the household savings rate in Japan has been falling from 15% in the 1980s to 2% in 2009 which is threatening Japan's net savings

**Figure 6 - United Kingdom Debt to GDP Ratios**



Source: International Monetary Fund, "World Economic Outlook Database April 2010," <http://www.imf.org/external/pubs/ft/weo/2010/01/weodata/index.aspx> (accessed August 15, 2010).

surplus and, in turn, its ability to export capital.<sup>55</sup> A Japanese liquidation of dollar assets would put downward pressure on the dollar. This in turn, would reduce the value of dollar holdings around the world, potentially causing other investors to begin selling their dollar securities before the bottom falls out. This would be the equivalent of a bank run on an international scale.

The United Kingdom's economic health poses a similar problem. Figure 6 illustrates that, while their debt levels are not as high as Japan's, they are predicted to rise above 90% of GDP within the next five years. The most concerning aspect of the United Kingdom's debt is the rapid rate of growth following 2007, doubling by 2012. As the United Kingdom faces its rapidly growing debt, likely accompanied with higher interest payments, it may not be able to purchase additional United States debt. As Table 7 showed, the United Kingdom has increased its holdings of United States Treasury Securities by \$271.4 billion over the last year. This has allowed the United States to continue financing the wars in Iraq and Afghanistan, as well as the large economic stimulus. However, an inability to purchase additional debt is not the real problem for the United Kingdom, much like the scenario with Japan; the problem emerges when the United Kingdom is forced to sell its reserves to cover its own payments or to intervene in a crisis that threatens its economy.

<sup>55</sup> Martin Feldstein, "Japan's Savings Crisis," Project Syndicate, <http://www.project-syndicate.org> (accessed October 13, 2010).

A resurgence of the sovereign debt crisis that hit Europe earlier this year could trigger such a scenario. Based on data in table 8, five high-risk nations owe the United Kingdom a total of \$418 billion. Three fourths of this amount is owed by Spain and Ireland, nations who have significant debt issues of their own.

**Table 8 - Debt Owed to the United Kingdom (billions of US dollars)**

Country	Debt to United Kingdom
Ireland	188
Spain	114
Italy	77
Portugal	24
Greece	15

Source: Bank for International Settlements, 2010

Spain and Ireland have both experienced setbacks in their efforts to avoid future defaults. The Irish have announced an initiative to spend billions to prop up its banking sector while Moody's downgraded Spain's credit rating on September 30, 2010 over concerns about its current financial condition and prospects for growth.<sup>56</sup> A default by either of these nations on obligations to the United Kingdom might force the United Kingdom to liquidate a significant portion of its dollar holdings. In either case, a major selloff of dollars by one of the top three holders could cause a panic, as investors would seek to sell their holdings before the value plummets.

## Impacts to National Security

Just as it is impossible to predict exactly what the future of the dollar holds, it is impossible to predict exactly the second and third order effects of a dollar collapse. However, the falling value of the dollar would have important consequences because of the United States' continued reliance on deficit financing. The inflow of foreign financing would be dramatically, if not wholly, reduced as the value of the dollar falls. Therefore, the United States would have to pay higher interest rates to fund future debt to offset the increasing uncertainty about its future value; this would place a restrictive constraint on future government spending. Any hope of covering this spending shortfall by increasing revenue through taxation is also unlikely to succeed in the short-term because of potential impacts to the domestic economy. Eventually, the economy would recover as the weaker dollar makes United States exports more affordable for the rest of the world.

Such a crisis would force the United States Government to make immediate spending cuts due to the loss of international funding. The fiscal year 2010 budget provides an example of the risk. The

<sup>56</sup> Wall Street Journal World at a Glance, "World Watch – Europe," Wall Street Journal Online, <http://online.wsj.com/article/SB10001424052748704483004575524032776735098.html> (accessed October 1, 2010).

Congressional Budget Office (CBO) projections for fiscal year 2010 anticipate \$2.175 trillion in revenue balanced against \$3.524 trillion in outlays.<sup>57</sup> The budget deficit for 2010 is then \$1.349 trillion. This accounts for nearly all of the discretionary spending for 2010, which is \$1.371 trillion.<sup>58</sup> In other words, the United States could only fund 1.6% of its 2010 discretionary spending without borrowing from foreign governments and private investors. This means that almost any disruption to the inflow of capital from these investors would force the government to suspend governmental operations, including overseas military operations or cut entitlements such as Social Security and Medicaid. Congress would likely try to spread the spending reductions across governmental functions, but the political reality is that cutting spending on overseas military operations is easier than cutting social programs for constituents.

Even modest reductions in government spending would affect funding support for the National Security Strategy. The 2010 National Security Strategy outlines four enduring national interests – *security* of the United States, its citizens, allies and partners; *prosperity* through a growing United States economy in an open international system; respect for universal *values* throughout the world; and an *international order* advanced by United States leadership and international cooperation.<sup>59</sup> Each of these national interests would be adversely affected by a dollar crisis.

A key component of the national interest in security is to disrupt, dismantle, and defeat terrorism around the world.<sup>60</sup> The frontline of this effort is in Afghanistan and Pakistan where the United States is fighting an insurgency, working to build an effective Afghan government, and looking to increase trust and respect with the Pakistani government while supporting their capacity to target extremists.<sup>61</sup> It is likely that these would be among the first casualties of budget cuts, as the American public would demand the government prioritize a severe domestic crisis over the enduring war effort. Even absent calls from the public, it is unlikely the United States could find a way to continue funding the \$165 billion required for wars in Iraq and Afghanistan in the face of a dollar crisis.<sup>62</sup> Beyond the immediate crisis, the higher interest rates that would be required on new debt following a crisis would also constrain the nation's ability to conduct future overseas military operations as it did for the British in the 1950s. Further undermining US security interests are the debt problems of our allies, who increasingly find themselves having to pit their domestic needs against the need for global security.

The remaining national interests of prosperity, values and international order would be undermined by the inability of the United States to continue funding international development institutions at current, and less than ideal levels. One policy nested within the prosperity interest is to increase investments in development in order to help developing countries grow into prosperous, democratic, and accountable states.<sup>63</sup> The United States' support to international institutions such as the IMF and World Bank are critical ways that the nation works toward an open international

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<sup>57</sup> Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2010 to 2020*, (Washington, DC: Government Printing Office, January 2010), 8.

<sup>58</sup> Ibid.

<sup>59</sup> Barack H. Obama, *The National Security Strategy of the United States*, (Washington, DC: The White House, May 2010), 17.

<sup>60</sup> Ibid., 19.

<sup>61</sup> Ibid., 21.

<sup>62</sup> Congressional Budget Office, *The Budget and Economic Outlook*, 6.

<sup>63</sup> Obama, *The National Security Strategy*, 33.

economic system while simultaneously promoting universal values and international cooperation. The United States may not be able to maintain its leadership role in these organizations following a dollar crisis, as it will become harder to maintain a higher level of financing relative to the other members. The United States could find itself reliant on the policy interests of another nation that may not weigh universal values, democracy, and international cooperation as highly as it does.

The case for fiscal year 2010 is extreme based on stimulus spending, however, it is also a fact that the government faces. The CBO projects that annual budget deficits will fall dramatically by 2020 behind significant increases in revenue, resulting in deficit levels equal to less than half of annual discretionary spending.<sup>64</sup> These revenue increases are not guaranteed; there is ongoing debate regarding the expiration of the Bush tax cuts in 2012 and future growth in revenue is linked to economic recovery. If realized, this structure will reduce the United States' vulnerability, but it does not eliminate it as the reliance on external funding remains and the overall debt burden continues to increase.

## Conclusion

The analysis indicates a synthesis of Kennedy and Ferguson's theories of great power decline. Economic foundations shift slowly over time, but the true frailty of the system is not apparent until a crisis tips the balance of power. Much of the United States' current international power has been derived from its economic strength, and the translation of that strength into leading roles in current international institutions such as the IMF and World Bank. However, there are indicators that this strength has turned into vulnerability due to excessive budget deficits financed by foreign nations with growingly fragile economic fundamentals.

Economists' views of international currencies and the case of the interrelated declines of the sterling and the United Kingdom indicate that there are a number of necessary conditions that can make a great power vulnerable. The loss of economic prominence—as measured in terms of GDP, gross government debt, and trade—weakened investor confidence in the sterling, while undermining its utility in the trade roles of an international currency. This resulted in diversification by central banks and private investors who replaced a portion of their sterling reserves with dollars. This reduced the inflow of foreign capital to the United Kingdom, led to its inability to continue making interest payments on debt owed to the United States. When the United States refused additional loans to Britain at the outset of World War II, it forced them to sell their gold reserves and illiquid income producing assets. In the end, the United Kingdom had relied too heavily on deficit spending supported by external sources. When these sources proved unwilling to provide further support, the United Kingdom and the sterling gave way to the United States and the dollar. This resulted in the loss of international leadership, but also lost autonomy as demonstrated by the Suez Crisis.

The United States is now following the same path as the nation's debt has grown rapidly in the midst of its own wars following the terrorist attacks on September 11, 2001. There is a long-term vulnerability in the trajectory of the United States' current account deficit and growing debt burden, which will undermine investor confidence in the dollar as a store of value. If foreign governments and private investors no longer view United States securities as a safe store of value, they will begin to diversify their reserve holdings. This combined with the United States' loss of its lead in world trade could result in the replacement of the dollar as the primary international currency. However,

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<sup>64</sup> Congressional Budget Office, *The Budget and Economic Outlook*, 8.

the evidence indicates that investors still feel that the dollar is a useful investment, either as a store of value, or as a highly liquid asset that provides a ready means to intervene in a domestic crisis. Therefore, the United States has time to make necessary adjustments before the dollar loses its predominant role. Change will require altering federal spending priorities to restore fiscal discipline. However, investors holding the dollar for its high liquidity create a different vulnerability, with potentially more immediate consequences.

If foreign governments are holding the dollar for its liquidity, the real danger to the United States international predominance may reside in the house of cards upon which its deficit spending relies. The largest, and fastest growing, investors in United States securities are heavily indebted themselves. This leaves the country vulnerable to a crisis that it cannot control. Looming crises in those nations could result in a run on the dollar, which would force the United States Government to make an immediate budgetary decision between national security and other spending. Defense cuts would undermine national security objectives as stated in the 2010 National Security Strategy and constrain ongoing overseas military operations and the nation's leadership role in international institutions. A dollar crisis could also result in the dollar's loss of status as the leading international currency, which poses long-term implications to national security, as the US would lose a measure of its autonomy as the United Kingdom did following World War II.

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